MISSOURI
PACIFIC
RAILROAD
SYSTEM
ANNUAL
REPORT

1977

Missouri Pacific System

TRANSFER AGENTS

United States Trust Company of New York
45 Wall Street
New York, N. Y. 10005

The Boatmen's National Bank of St. Louis
100 N. Broadway
St. Louis, Mo. 63102

REGISTRARS

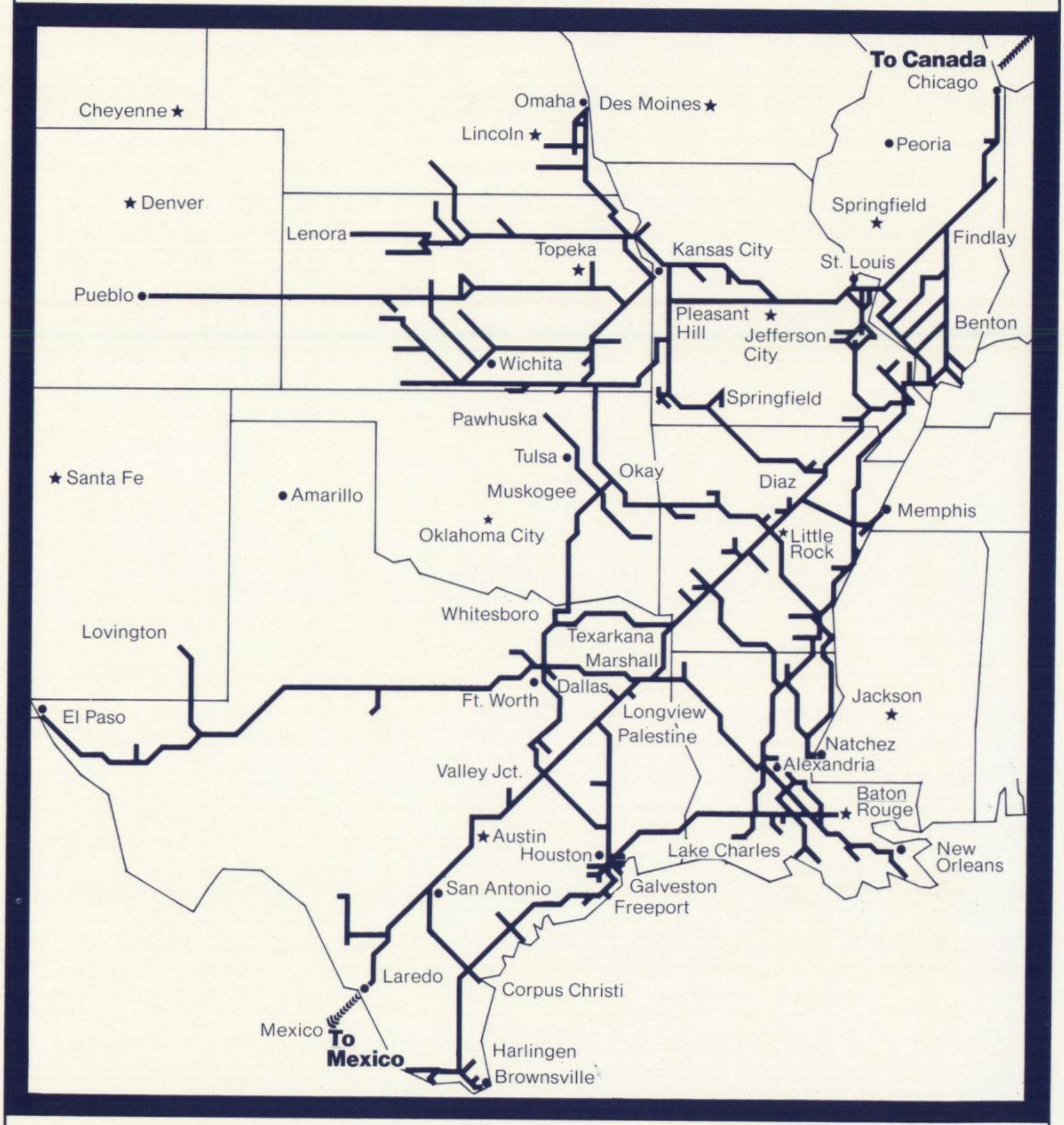
Manufacturers Hanover Trust Company
4 New York Plaza
New York, N. Y. 10004

St. Louis Union Trust Company
510 Locust Street
St. Louis, Mo. 63101

DIVIDEND DISBURSING AGENT

The Boatmen's National Bank of St. Louis

Annual Meeting of Stockholders
The Second Tuesday
in May
General Offices
Missouri Pacific Building
St. Louis, Mo. 63103


To Canada
Chicago
Cheyenne
Omaha
Des Moines
Lincoln
Peoria
Denver
Springfield
Lenora
Findlay
Topeka
Kansas City
St. Louis
Pueblo
Pleasant Hill
Jefferson City
Benton
Wichita
Springfield
Pawhuska
Tulsa
Okay
Santa Fe
Diaz
Amarillo
Muskogee
Oklahoma City
Memphis
Little Rock
Whitesboro
Lovington
Texarkana
Marshall
Dallas
Ft. Worth
El Paso
Longview
Jackson
Palestine
Natchez
Valley Jct.
Alexandria
Baton Rouge
Austin
Houston
Lake Charles
New Orleans
San Antonio
Galveston
Freeport
Laredo
Corpus Christi
Mexico
To Mexico
Harlingen
Brownsville

The Mo-Pac System totals nearly 12,000 miles of railroad supplemented by 19,000 miles of highway routes. It has railroad operations in 12 states in the midwest, south and southwest, and through its subsidiaries also performs a wide variety of intermodal services including trucking, piggyback, containerization, less-than-truckload freight and airfreight forwarding.

Board of Directors

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President, The Central Trust Bank, Jefferson City, Mo.

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Senior partner of the law firm of Smith, Williams, Friday, Eldredge & Clark, Little Rock

****HERBERT GUSSMAN**
Independent oil producer and investments, Tulsa

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Senior Vice President and General Counsel, Missouri Pacific Railroad, Executive Vice President, Missouri Pacific Corp., St. Louis

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Chairman of the Board and President, Commerce Bancshares, Inc., Kansas City

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Vice President and Business Manager, Northwestern University, Evanston, Ill.

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Vice President, The Dow Chemical Co., Midland, Mich.

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President and Chief Executive Officer, Missouri Pacific Railroad, St. Louis

ROMULO O'FARRILL, JR.
Chairman of the Board, Televisa S.A. (television station operation), Vice President and Editor-in-Chief of seven Mexican newspapers, Vice President, Impresora Y Editora Mexicana (magazine publishing and printing), Vice President, Automotriz O'Farrill (automobile distribution), Mexico City

***††THOMAS H. O'LEARY**
President, Missouri Pacific Corp., which controls subsidiaries involved in railroad operations (Missouri Pacific System), production/transmission of natural gas and cement manufacturing, St. Louis

***W. M. SHAPLEIGH**
President, Ralston Purina Co., diversified food processor, St. Louis

***HAROLD E. THAYER**
Chairman of the Board and Chief Executive Officer, Mallinckrodt, Inc., manufacturers of chemicals and pharmaceuticals, St. Louis

••F. B. WADELTON
Management consultant, Red Bank, N.J.

*Executive Committee
†Finance Committee
•Audit Committee
**Chairman of Executive Committee
††Chairman of Finance Committee
••Chairman of Audit Committee

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Chairman of the Board, St. Louis

J. H. LLOYD
President and Chief Executive Officer, St. Louis

J. W. GESSNER
Executive Vice President, St. Louis

M. M. HENNELLY
Senior Vice President and General Counsel, St. Louis

J. A. AUSTIN
Senior Vice President-Traffic, St. Louis

R. K. DAVIDSON
Senior Vice President-Operation, St. Louis

W. R. McDOWELL
Vice President and General Counsel (Southern Lines), Dallas

J. G. GERMAN
Vice President-Engineering, St. Louis

J. M. TOLER
Vice President-Transportation, St. Louis

D. L. MANION
Vice President-Administration, St. Louis

G. S. SINES
Vice President-Information and Control Systems, St. Louis

J. E. ANGST
Vice President, St. Louis

G. A. CRAIG
Vice President, Houston

C. A. ROBERTS
Vice President, New Orleans

H. S. VIERLING
Vice President, Chicago

J. C. DURAND
Vice President, Washington, D.C.

E. F. BECKTAME
Controller, St. Louis

C. J. MAURER
Secretary and Treasurer, St. Louis

Consolidated Financial and Operating Highlights

for the year ended December 31, 1977

	1977	1976
Income and Expense Items:		
Operating Revenues	**$1,127,155,000**	$1,013,668,000
Operating Expenses	**824,326,000**	747,242,000
Operating Ratio (Rail Line)	**71.6%**	72.3%
Income Available for Fixed Charges	**171,277,000**	147,482,000
Times Fixed Interest Earned	**4.2**	4.1
Net Income	**108,882,000**	68,696,000
Earnings Per Common and Common Equivalent Share	**8.08**	5.40
Financial Position:		
Gross Capital Expenditures	**$ 169,570,000**	$ 131,041,000
Depreciation and Retirements Charged to Income	**51,696,000**	45,964,000
Working Capital	**80,235,000**	45,282,000
Long Term Debt	**805,368,000**	753,025,000
Stockholders' Equity	**619,916,000**	532,717,000
Freight Statistics:		
Miles of Railroad Operated	**11,620**	11,674
Revenue Ton Miles (1,000's)	**48,653,779**	45,755,953
Revenue Per Ton Mile (cents)	**2.15**	2.06
Employees:		
Total Amount of Payroll	**$ 404,643,000**	$ 372,596,000
Average Annual Wages	**19,118**	17,664
Average Number of Employees	**21,165**	21,094

Financial/ Corporate

RECORD FINANCIAL RESULTS

Consolidated net income for the Missouri Pacific Railroad System in 1977 was a record $108,882,000 compared to $68,696,000 in 1976, an increase of 58.5 per cent. Earnings per share of Common stock were $8.08 in 1977 compared to $5.40 the previous year. Consolidated net income in 1977 included $21,756,000 of non-recurring investment tax credits which were generated in previous years. Excluding these credits, earnings would have been $87,126,000.

Consolidated operating revenues rose from $1,013,668,000 in 1976 to $1,127,155,000 in 1977.

Capital expenditures for 1977 totaled a record $169,570,000. Missouri Pacific lowered its operating ratio, the ratio of expenses to revenue, from 72.3 to 71.6 per cent.

A general rate increase was granted on November 30 that should generate approximately $40 million additional revenue in 1978. However, the additional revenue still falls short of meeting current and anticipated higher costs of labor, materials and supplies.

Dividends paid per share of Common stock in 1977 totaled $1.59 compared to $1.25 in 1976.

STOCKHOLDERS APPROVE MERGER

At a special stockholders meeting held on December 9, 1977, stockholders of the Missouri Pacific Railroad Company approved a Plan and Joint Agreement of Merger and Consolidation by which Mo-Pac, which is presently a 92.3% owned subsidiary of Missouri Pacific Corporation (MPC), will become a wholly-owned subsidiary of MPC. As part of the merger, Mo-Pac and seven of its wholly owned subsidiaries will be merged into a recently formed Delaware corporation wholly owned by MPC. Upon the effectiveness of the proposed merger each share of Mo-Pac Common stock held by stockholders other than MPC will be converted into ninety-five hundredths (0.95) of a share of MPC Common stock.

Modernization

RECORD CAPITAL EXPENDITURES

The Missouri Pacific Railroad System invested a record $169,570,000 in capital expenditures during 1977. This sum included $135,435,000 for the acquisition of 55 locomotives, 3,213 freight cars and 310 multi-level auto racks, as well as 100 cabooses built in System shops.

The System's capital expenditures for the five years ended December 31, 1977 are set forth in the following table:

	1977	1976	1975	1974	1973
	(Thousands of Dollars)				
Road	**$ 29,129**	$ 25,007	$ 26,391	$ 20,296	$ 18,903
Equipment	**139,616**	101,910	72,159	84,371	39,171
Miscellaneous Physical Property	**825**	4,124	5,409	133	1,314
Total	**$169,570**	$131,041	$103,959	$104,800	$ 59,388

In addition to acquisition of new freight equipment, Mo-Pac shop forces repaired 8,986 freight cars, resulting in an increase in the average number of cars in service from 94.7 per cent in 1976 to 96 per cent the past year.

INTENSIVE TRACK IMPROVEMENTS

The Company is continuing its emphasis on maintaining a track structure capable of handling increased traffic without delays. In addition to the improvements shown below for 1977, eighteen new bridges, totaling 2,398 lineal feet, were constructed.

The following table summarizes certain maintenance, additions and betterments to the System's rail property for the five years ended December 31, 1977:

	1977	1976	1975	1974	1973
Track miles of rail replaced					
New	**268**	234	206	206	193
Secondhand	**230**	260	84	152	122
Miles of newly-constructed track	**35.93**	19.05	33.46	44.18	51.02
Track miles surfaced or reballasted	**5,081**	6,891	3,537	4,134	4,774
Ties inserted (In thousands)	**1,329**	1,545	954	900	1,000

INTERMODAL FACILITIES EXPANDED

Intermodal facilities at Chicago were doubled in capacity during 1977 and a new intermodal terminal was opened at Shreveport, La. Houston intermodal installations also were expanded. In addition, a new auto unloading facility was constructed at Port Allen, La., and the auto facility at Arlington, Texas was expanded. New yard office buildings were completed at Natchez, Miss. and Mineola, Texas. Construction of an enclosed building for freight car repairs began late in the year at Dupo, Ill., south of St. Louis.

Sales/ Marketing/ Service

TRAFFIC SURPASSES INDUSTRY PERFORMANCE

In terms of growth in freight revenues, revenue ton-miles and carloadings, the Missouri Pacific Railroad System performed above the level of the national railroad industry.

Mo-Pac carloadings advanced 5 per cent compared to a 0.7 per cent decrease for the industry while revenue ton-miles, a more accurate measurement of traffic activity, rose 6.3 per cent compared to a national increase of 2.7 per cent. Freight revenues for Mo-Pac were 11.3 per cent above the level of 1976 while the industry was expected to report a gain of about 6.7 per cent.

NEARLY ALL MARKETS POST TRAFFIC INCREASES

Missouri Pacific performed strongly in 1977 after disappointing results in January and February due to harsh weather, and continued its strong performance through the close of the year.

Chemicals, automobiles and automobile parts and grain traffic, the three most important markets in terms of revenue, increased in 1977 with chemical revenue ton-miles up 14.5 per cent, auto traffic up 3.3 per cent and grain traffic up 9.9 per cent.

Again, on the basis of revenue ton-miles, lumber traffic rose 7.4 per cent, paper products rose 3.7 per cent and aggregates were up 8.4 per cent. Metals traffic grew 4.5 per cent while food products declined 3.4 per cent.

Piggyback and container traffic continued its strong growth trend with an increase of 16.2 per cent for Missouri Pacific compared to a gain of 11.9 per cent for the railroad industry.

Although coal carloadings were up 5.4 per cent, results were not as good as had been anticipated because of the miners strike which started in December.

NEW INDUSTRY SETS RECORD

Estimated capital investment by industry in 169 new or expanded facilities along the Missouri Pacific Railroad reached a record $1.6-billion in 1977 after surpassing $1-billion for the first time in 1976.

In addition, there are 100 major new or expanded industrial plant projects which have been announced for construction on the Missouri Pacific during the next five years, representing an estimated investment of $13-billion. This includes 30 chemical industry projects with an estimated $3.71-billion plant investment.

MARKETING RAISES REVENUES

Development of new pricing plans covering a wide range of commodities and establishment of new rates on trainload and multiple carload coal transported from the western states produced more than $25-million in additional revenue. A substantial portion of this revenue was produced by new freight business.

TRAIN SERVICE EXPANDED AND IMPROVED

The Operating Department was active in implementing increased service along strategic routes and frequent adjustments of existing schedules to meet customer needs.

An additional piggyback train was inaugurated to run three days weekly from Chicago and daily from Little Rock to Dallas. A second run-through train with the Atchison, Topeka and Santa Fe Railroad was established for service to and from the West Coast through Sweetwater, Texas. A second chemical train was put into service from Angleton, Texas to St. Louis and Chicago connecting routes. A new coal unit train was put into service with the Burlington Northern.

Car utilization was further improved and the railroad handled its substantial traffic increase more efficiently than in 1976 as measured by such indices as train miles, car-hire expense, gross ton-miles per yard engine hour and the ratio of loaded cars to empty cars. The "Clearing House" experiment initiated by Mo-Pac with the Southern Railway and the Milwaukee Road, which permits freer use of certain types of freight cars, was extended to 10 more railroads. The experiment has produced gains in car utilization.

Intermodal Operations

Missouri Pacific continued to improve its position as a full-service transportation agency in 1977 with gains in piggyback and container traffic as well as expansion of its trucking and airfreight forwarding operations.

In addition to a 16.2 per cent increase in piggyback traffic, Mo-Pac posted an excellent 56 per cent increase in container loadings. Most of the increase in containerization was new West Coast-Gulf Coast traffic.

TRUCKLINE MERGED

Effective June 1, the wholly-owned Texas and Pacific Motor Transport Company was merged into the Missouri Pacific Truck Lines. This has produced savings in internal expense associated with accounting and management reports.

The truckline also increased its revenues by 9.6 per cent for 1977. The marketing department was reorganized and centralized in St. Louis to provide quicker response to shipper needs. Also centralized in St. Louis was the line-haul dispatch function, which monitors equipment utilization and service.

AIRFREIGHT TO EXPAND

Missouri Pacific Airfreight increased revenues by 20 per cent and opened a new station in Philadelphia during 1977 in addition to off-line stations already in operation at Los Angeles, San Francisco and New York. Accelerated expansion to off-line points is planned during 1978, with as many as six new stations anticipated.

People

KEY MANAGEMENT CHANGES

Mark M. Hennelly was elected senior vice president and general counsel; Joseph A. Austin was elected senior vice president-traffic and Richard K. Davidson was elected senior vice president-operation at the May Board meeting. At the same meeting, Guerdon S. Sines was elected vice president-information and control systems. George A. Craig, formerly assistant vice president-sales & service, was elected vice president-Houston effective August 1, succeeding J. Glen Sheppard, who retired. Edward F. Becktame was named controller, succeeding Thomas D. Rodman, deceased.

IN-HOUSE EDUCATION INCREASED

During 1977, Mo-Pac established a special course in rate making and analysis for customer personnel and a TCS Training Center for instruction of field personnel and supervisors in the use of TCS programs. The rate training course has been utilized by the U.S. government, several major corporations and by Japanese steamship lines and trading companies. The TCS Training Center handled 132 employees from August to the close of the year.

MANAGEMENT DEVELOPMENT AND MINORITIES

The Company continued its efforts to recruit recent college graduates for its management development programs in operations, sales, marketing, accounting and data systems. During the year 33 persons joined the program.

Mo-Pac has been among the most active railroads in hiring and transferring women to non-traditional jobs such as train operations, maintenance and materials handling. More than 100 women have been assigned to such positions with a retention rate of more than 90 per cent.

The Company has also entered into an agreement with the federal government on a cost-sharing basis to provide on-the-job training for unemployed members of minority groups and Vietnam-era veterans. Missouri Pacific was the first major railroad to receive approval from the General Services Administrations for its affirmative action compliance program.

Computer Systems

GAINS MADE IN EXPANSION OF COMPUTER SYSTEMS

Significant advances in computer technology were achieved as Mo-Pac's Transportation Control System (TCS) moved toward an advanced stage of development.

A new car distribution system was implemented in 1977. It makes all freight car data available to car distribution forces by computer. In daily use the customer simply contacts one of Mo-Pac's 60 Customer Service Centers and orders the precise kind of equipment required and the number of cars needed each day. The Customer Service Center clerk then makes the customer's needs known to the central computer complex in St. Louis through his own data device. A group of professional car distributors in St.Louis uses the computer to find "candidate cars" for the customer's order. The proper cars are assigned to the customer's order and then may be traced as they move toward the customer.

Mo-Pac was the first railroad to develop a computer-generated hazardous materials emergency response system. All crewmen on trains carrying potentially hazardous materials are provided detailed instructions for each car, by its position in the train, on the proper measures to be undertaken in the event of a derailment or other type of accident.

A major breakthrough was made in December when Mo-Pac announced operation of a new system pioneered with Phillips Petroleum which permits computer-to-computer production of waybills and bills of lading. The system, called CoMPuBill, is based on Missouri Pacific's AutoBill system, which provides computer-generated billing for freight upon entry of a customer code and certain variable information into the computer when the customer calls a Customer Service Center.

Throughout the year, various subsystems of TCS were expanded to more on-line locations. Work also began on creating programs which will permit Mo-Pac complete monitoring of piggyback trailers and containers after they leave the rails.

INDUSTRY EDUCATION EFFORTS CONTINUE

High priority is placed on programs to educate and help customers and other users of TCS to understand and utilize the system. This includes seminars, a variety of brochures and, beginning in 1978, a widespread educational advertising program.

In May, Mo-Pac joined with the Federal Railroad Administration in conducting a seminar on car scheduling for the railroad industry. Mo-Pac is developing under an FRA contract a system for industry use which will permit precise scheduling and performance monitoring of each freight car in transit.

Specialists from Operations, Market Research and TCS also conducted 15 seminars across the nation during 1977 to acquaint shippers with the main features of TCS. Computer equipment was transported to each seminar site, where it was connected to the central Mo-Pac computer complex in St. Louis, to provide a realistic demonstration of TCS. This program will continue in 1978.

JH Lloyd

John H. Lloyd
President and Chief Executive Officer

February 13, 1978

ANNUAL REPORT FORM 10-K TO SECURITIES AND EXCHANGE COMMISSION

Interested stockholders may obtain a copy of the Missouri Pacific Railroad's Form 10-K, including financial statements and schedules, filed with the Securities and Exchange Commission for the year ended December 31, 1977, at no charge by writing to:

Office of Controller
Missouri Pacific Railroad Company
210 N. 13th Street
St. Louis, Mo. 63103

QUARTERLY FINANCIAL INFORMATION — UNAUDITED

(In Thousands of Dollars Except Per Share Data)

		First	Second	Third	Fourth	Total
Operating Revenues	1977	$266,874	$290,070	$279,820	$290,391	$1,127,155
	1976	246,173	253,897	253,841	259,757	1,013,668
Net Operating Income	1977	34,086	39,821	34,549	42,409	150,865
	1976	25,608	29,795	30,837	39,025	125,265
Net Income	1977	21,673	26,023	24,599	36,587	108,882
	1976	14,626	15,295	15,122	23,653	68,696
Earnings Per Common and Common Equivalent Share	1977	1.61	1.93	1.83	2.71	8.08
	1976	1.17	1.22	1.21	1.80	5.40
Dividends Paid Per Share						
Common	1977	.36½	.36½	.43	.43	1.59
	1976	.30	.30	.32½	.32½	1.25
Preferred	1976	.25	.25	.25	.25	1.00
Stock Exchange Prices						
Common Stock						
American Stock Exchange	1977					
	High	43	46¾	43½	43¼	
	Low	31½	40⅞	37⅝	37⅝	
	1976					
	High	30½	32½	32	32	
	Low	17¾	27⅝	27⅝	27⅜	
Preferred Stock						
New York Stock Exchange	1976					
	High	30	32⅛	31½	32¼	
	Low	17¾	27½	27½	27	

Consolidated Statement of Income
(In Thousands of Dollars)

	Year Ended December 31,	
	1977	1976
Operating Revenues:		
Freight	**$1,091,586**	$ 981,005
Switching and Other	**35,569**	32,663
Total Operating Revenues	**1,127,155**	1,013,668
Operating Expenses: (Notes 1 and 2)		
Maintenance of Way and Structures	**162,673**	140,098
Maintenance of Equipment	**176,929**	159,338
Traffic	**21,972**	19,669
Transportation	**422,187**	390,355
General	**40,565**	37,782
Total Operating Expenses	**824,326**	747,242
Net Revenue from Operations	**302,829**	266,426
Other Operating Charges: (Note 5)		
Taxes (Except Federal Income Taxes)	**86,657**	79,661
Equipment and Joint Facility Rents	**65,307**	61,500
Total Other Operating Charges	**151,964**	141,161
Net Operating Income (Before Federal Income Taxes)	**150,865**	125,265
Other Income (Net):		
Gain on Reacquisitions of Long Term Debt	**4,482**	6,726
Other, Net	**15,930**	15,491
Total Other Income	**20,412**	22,217
Income Available for Fixed Charges (Before Federal Income Taxes)	**171,277**	147,482
Interest:		
Fixed	**40,750**	35,991
Contingent	**9,813**	9,782
Total Interest	**50,563**	45,773
Income Before Federal Income Taxes and Minority Interests	**120,714**	101,709
Provision for Federal Income Taxes: (Note 2)		
Current	**46,465**	35,656
Deferred	**10,907**	12,183
Investment Tax Credits Utilized		
Generated Current Year	**(23,784)**	(17,793)
Generated Prior Years (Non-recurring)	**(21,756)**	
Total Federal Income Taxes	**11,832**	30,046
Income Before Minority Interests	**108,882**	71,663
Less — Income Applicable to Minority Interests		2,967
Net Income	**$ 108,882**	$ 68,696
Earnings Per Common and Common Equivalent Share (Notes 1 and 4)	**$ 8.08**	$ 5.40
Depreciation and Retirement Charges Included Above (Note 1)	**$ 51,696**	$ 45,964

See Notes to Consolidated Financial Statements, Pages 14-18.

Consolidated Balance Sheet

Assets
(In Thousands of Dollars)

	Dec. 31, 1977	Dec. 31, 1976
Current Assets:		
Cash and Temporary Cash Investments	**$ 145,946**	$ 116,833
Deposits for Interest, Dividends and Equipment Acquisition	**25,535**	14,403
Accounts Receivable	**97,936**	76,264
Refundable Federal Income Taxes	**5,195**	
Material and Supplies, at average cost	**44,438**	47,675
Accumulated Deferred Federal Income Tax Benefits	**19,695**	18,036
Other Current Assets	**2,480**	2,164
	341,225	275,375
Properties: (Notes 1 and 4)		
Road	**911,634**	890,276
Equipment	**1,144,175**	1,040,661
Miscellaneous	**41,491**	39,022
	2,097,300	1,969,959
Less:		
Accumulated Depreciation		
Road	**141,940**	135,813
Equipment	**401,046**	387,655
Miscellaneous	**14,164**	12,364
	1,540,150	1,434,127
Other Assets and Deferred Charges:		
Investment in Terminal and Other Companies (Note 1)	**42,123**	41,923
Capital, Insurance and Other Funds (Note 6)	**28,928**	20,697
Other	**6,413**	6,843
	77,464	69,463
	$1,958,839	$1,778,965

Liabilities (In Thousands of Dollars)	**Dec. 31, 1977**	Dec. 31, 1976
Current Liabilities:		
Accounts and Wages Payable	**$ 118,021**	$ 108,494
Current Maturities of Long Term Debt	**45,081**	39,642
Unmatured Interest Accrued	**18,050**	16,434
Interest and Dividends Payable	**7,053**	6,824
Federal Income Taxes Accrued		7,377
Other Taxes Accrued	**24,649**	19,826
Other Current Liabilities	**48,136**	31,496
	260,990	230,093
Long Term Debt (Page 12)	**805,368**	753,025
Other Liabilities and Deferred Credits:		
Accumulated Deferred Federal Income Taxes	**215,798**	203,232
Casualty Reserves and Other Liabilities (Note 6)	**56,767**	59,898
	272,565	263,130
Stockholders' Equity: (Note 3)		
$1 Cumulative Convertible Preferred Stock — No Par Value; Authorized 10,000,000 shares; Outstanding 156,560 shares at December 31, 1976		3,131
Common Stock — No Par Value; Authorized 15,000,000 shares; Outstanding 13,466,206 and 13,323,202 shares, respectively	**203,891**	201,031
Capital Surplus	**1,451**	1,451
Retained Income (Page 12)	**414,574**	327,104
	619,916	532,717
Commitments and Contingent Liabilities (Notes 5 and 6)		
	$1,958,839	$1,778,965

See Notes to Consolidated Financial Statements, Pages 14-18.

Consolidated Statement of Retained Income

(In Thousands of Dollars)

	Year Ended December 31, 1977	1976
Balance at Beginning of Year	**$327,104**	$273,848
Add — Net Income	**108,882**	68,696
	435,986	342,544
Deduct — Cash Dividends —		
Preferred Stock — $1.00 Per Share in 1976		2,471
Common Stock — $1.59 Per Share in 1977 and $1.25 Per Share in 1976	**21,412**	12,969
Balance at End of Year (Note 3)	**$414,574**	$327,104

See Notes to Consolidated Financial Statements, Pages 14-18.

Long Term Debt (Including Maturities in 1978)

(In Thousands of Dollars)

	Interest Rate	Date of Maturity	Changes 1977		Outstanding December 31, 1977 (excluding amounts held by Company)
			Issued	Reduction	
Missouri Pacific Railroad Company					
First Mortgage Bonds (1)	4¼%	1990 & 2005		$13,399	$215,658
First Mortgage Bonds	5%	2000			18,961
First Mortgage Bonds (1)	3⅝%	1980		410	1,017
Second Mortgage Bonds	5%	2000		1	3
General Mortgage Bonds (1)	4¾% (2)	2020 & 2030		500	101,308
General & Refunding Mortgage Bonds (1)	3⅞%	1985		1,339	2,869
Income Debentures	5% (2)	2045			100,016
Income Debentures (1)	5%	2054			1,704
Equipment Obligations	4% to 11¼%	1978 to 1992	$114,835	35,968	391,492
Promissory Notes	6% & 8%	1978 to 1987	734		734
Majority-Owned Subsidiaries	4½% to 8%	1978 to 1985		6,170	16,687
Grand Total			$115,569	$57,787	$850,449

	1978	1979	1980	1981	1982
Long Term Debt Maturing During Each of the Next Five Years	$45,081	$43,377	$43,857	$39,991	$36,090

(1) Have annual sinking fund requirements. (2) Contingent interest.
Substantially all properties are covered by liens of the mortgages or under the equipment obligations.

Consolidated Statement of Changes in Financial Position

(In Thousands of Dollars)

	Year Ended December 31,	
	1977	1976
Financial Resources Were Provided By:		
Net Income	**$108,882**	$ 68,696
Add — Charges (Credits) Against Income Not Requiring Working Capital —		
Depreciation and Retirements	**51,696**	45,964
Increase (Decrease) in Long Term Casualty and Other Reserves	**(2,066)**	8,755
Deferred Federal Income Taxes	**12,566**	15,401
Income Applicable to Minority Interests		2,967
Gain on Reacquisition of Long Term Debt	**(4,482)**	(6,726)
Other, Net	**(1,151)**	15
Working Capital Provided from Operations	**165,445**	135,072
Salvage from Property Sold or Retired	**10,736**	8,195
Proceeds from Equipment Obligations Issued	**114,835**	73,843
Proceeds from Other Long Term Debt Issued	**734**	3,543
Capital Fund Deposit Decrease		7,205
Other, Net	**1,334**	
	293,084	227,858
Financial Resources Were Used For:		
Property Additions	**169,570**	131,041
Reduction of Long Term Equipment Obligations	**46,552**	39,158
Repayment of Long Term Debt	**12,181**	13,075
Reduction of Long Term Bank Loan		6,000
Dividends (Including Amounts Paid Minority Interests)	**21,412**	15,677
Capital Fund Deposit Increase	**8,416**	
Other, Net		1,815
	258,131	206,766
Increase in Working Capital	**$ 34,953**	$ 21,092
Analysis of Changes in Working Capital:		
Cash and Temporary Cash Investments	**$ 29,113**	$ 28,519
Accounts Receivable	**21,672**	(612)
Refundable Federal Income Taxes	**5,195**	
Material and Supplies	**(3,237)**	7,988
Accumulated Deferred Federal Income Tax Benefits	**1,659**	3,218
Other Current Assets	**11,448**	8,728
Accounts and Wages Payable	**(9,527)**	(2,338)
Current Maturities of Long Term Debt	**(5,439)**	(4,244)
Federal Income Taxes Accrued	**7,377**	696
Other Current Liabilities	**(23,308)**	(20,863)
Increase in Working Capital	**$ 34,953**	$ 21,092

See Notes to Consolidated Financial Statements, Pages 14-18.

Notes to Consolidated Financial Statements

Note 1 — Summary of Significant Accounting Policies:

Principles of consolidation — The accompanying consolidated financial statements of the Missouri Pacific System include the accounts of the Missouri Pacific Railroad Company and its majority-owned subsidiaries. Investments in less than majority-owned terminal railroad companies (joint ventures) and other affiliated companies, where the Company has the ability to exercise significant influence over their operating and financial policies, are accounted for under the equity method.

Industry — Substantially all of the Company's operations are in the railroad industry.

Revenue recognition — Freight revenues are recognized upon completion of service.

Properties — Properties are stated primarily at estimated original cost, as determined by January 1, 1955 Interstate Commerce Commission valuations, plus additions and betterments at cost and less retirements since the dates of valuations.

The companies follow the straight-line method of depreciation using various group rates prescribed by the Interstate Commerce Commission. Depreciation provisions during 1977 and 1976 were at rates of approximately 3.9% and 3.8%, respectively, for equipment and 2.8% and 2.5%, respectively, for depreciable road properties. However, for rail, ties and other track materials, instead of depreciation accounting, the companies follow an acceptable alternate practice of "replacement" accounting. Under this method, replacements in kind are charged to expense while additions and betterments (improvements) are capitalized. The amounts capitalized are not depreciated and are charged against income only when the related properties are retired. Normal retirements of depreciable property are charged to the appropriate depreciation reserve at cost less salvage. At December 31, 1977 and 1976, consolidated nondepreciable properties, including land and land rights, were approximately $580,000,000 and $568,000,000, respectively (net of approximately $49,236,000 of allocated credit excess discussed in Note 4).

Federal income taxes — The accompanying consolidated financial statements include provisions for current and deferred federal income taxes. Current federal income taxes have been reduced by the benefits of tax deductions for accelerated depreciation and amortization of properties in advance of such deductions for financial statement purposes. These benefits have been partially offset by the effects of financial statement expense accruals for casualties and other matters which are not deducted for income tax purposes until paid. The net current benefit of these timing differences has been offset by a provision for deferred federal income taxes.

The Company is included in the Missouri Pacific Corporation (MPC) consolidated tax return; however, federal income taxes are provided as if a separate tax return is filed.

Investment tax credit is accounted for under the flow-through method as realized in the tax return.

Report of Independent Accountants

Price Waterhouse & Co.

To the Stockholders and Board of Directors of
MISSOURI PACIFIC RAILROAD COMPANY

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income and retained income and of changes in financial position present fairly the financial position of Missouri Pacific Railroad Company and its subsidiaries at December 31, 1977 and 1976, and the results of their operations and the changes in their financial position for the years then ended, in conformity with generally accepted accounting principles consistently applied. Our examinations of these statements were made in accordance with generally accepted auditing standards and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Price Waterhouse & Co.

St. Louis, Missouri
February 13, 1978

Per share data — Earnings per common and common equivalent share include the Preferred Stock as a common stock equivalent on a one-for-one basis until its redemption on January 17, 1977. The weighted average number of common shares and common share equivalents outstanding during 1977 and 1976 were 13,467,249 and 12,731,476, respectively.

Pensions — The companies have a funded, noncontributory pension plan for substantially all "nonscheduled" (non-union) employees. Related charges to operating expense, which amounted to $7,546,000 in 1977 and $7,167,000 in 1976, include normal cost, amortization of prior service cost over a 35-year period ending January 1, 2001, and interest on the recorded unfunded pension liability.

Normal costs are funded currently and prior service costs are funded over a 30-year period ending January 1, 2006. The actuarially computed value of vested benefits and benefits pertaining to retired employees exceeded the market value of the pension fund and the recorded pension liability by approximately $26,699,000 at December 31, 1977.

Casualty losses — Casualty losses not covered by insurance are accrued and charged to income as they are incurred (see Note 6).

Debt and related expenses — Discount, premium and expense applicable to long term debt is deferred and amortized over the lives of the respective issues using the bonds outstanding method. Gain on reacquisition of bonds is recorded as income.

Note 2 — Federal Income and Employment Taxes

Federal Income Taxes — Total federal income tax expense amounted to $11,832,000 in 1977 and $30,046,000 in 1976, an effective tax rate of 9.8% and 29.5%, respectively. The differences between the effective rates and the federal income tax rate of 48% result primarily from investment tax credit which amounted to $45,540,000 (including $21,756,000 of nonrecurring carryovers from prior years) in 1977 and $17,793,000 in 1976. The Tax Reform Act of 1976 contains a provision permitting railroads to utilize available investment tax credit to offset up to 100% of their federal income tax liability in 1977 and 1978. Beginning in 1979, the investment tax credit limitation will be reduced 10% annually until it returns to a 50% limitation in 1983. At December 31, 1977, there were no unused investment tax credit carryovers.

As described in Note 1, provisions for deferred federal income taxes result from timing differences in the recognition of revenue and expense for tax and for financial statement purposes. The sources of these differences and the tax effect of each are as follows (in thousands):

	Year Ended December 31,	
Source	**1977**	1976
Excess of tax over book depreciation and amortization	**$14,363**	$15,892
Financial statement expense accruals for casualties and other matters which are not deducted for tax purposes until paid	**755**	(6,553)
Reduction of property base for gain on reacquisition of bonds	**2,152**	3,228
IRS adjustments of 1973 and 1974 tax years —		
Maintenance of way expenses capitalized	**(1,750)**	
Improvements and various other expenses capitalized	**(2,773)**	
Other	**(1,840)**	(384)
Provision for deferred federal income taxes	**$10,907**	$12,183

In 1977 the Company adopted a Tax Reduction Act Stock Ownership Plan (TRASOP) established by MPC for the benefit of substantially all "nonscheduled" (non-union) employees of the Company. Investment tax credits for 1977 include $2,162,000 related to the Plan and a like amount has been charged to operating expenses so that there is no effect on net income. Under the TRASOP, contributed MPC stock will be allocated among participating employees but held for them for future distribution in accordance with the applicable provisions of the Internal Revenue Code. The Plan is subject to the approval of the IRS.

Employment taxes — An assessment by the Internal Revenue Service for employment tax deficiencies is imminent against the Company for the years 1971 - 1974 on the basis that Missouri Pacific Truck Lines, Inc. (MPTL), a wholly owned subsidiary of the Company, and Texas and Pacific Motor Transport Co. (TPMT), a former subsidiary now merged into MPTL, were "employers" for purposes of the Railroad Retirement Tax Act (RRTA) and therefore subject to higher employment tax rates than rates provided for by the Federal Insurance Contributions Act. This assessment is based on the presumption that all the employees of MPTL and TPMT were involved in railroad related activities in those years and should have been covered under RRTA. In the opinion of the Company's legal counsel, a substantial number of the truck line employees have not been involved in railroad related activities and the Company intends to fully contest this matter. Management believes that liability, if any, resulting from this matter will not be material in relation to the consolidated financial position or results of operations of the Company.

Note 3 — Stockholders' Equity:

During 1976 MPC increased its ownership in the Company from 66.3% to 92.3% primarily as a result of an exchange offer completed on June 25, 1976.

In October, 1976, 972,772 shares of the Company's Common Stock were issued in connection with the merger described in Note 4.

Effective January 17, 1977, all of the Company's outstanding Preferred Stock (13,556 shares) was redeemed at a price of $20 per share plus accrued dividends of $.045 per share. Prior to January 17, 1977, each share of Preferred Stock was convertible into one share of Common Stock and during 1977 and 1976 such conversions totaled 143,004 and 5,561,343 shares, respectively. The Common Stock account was credited with the stated value of the converted preferred shares. At December 31, 1977 and 1976 the Common Stock had a stated value of $15.14 and $15.09 per share, respectively.

On December 9, 1977, stockholders of the Company approved a Plan and Joint Agreement of Merger and Consolidation which provides that the Company will become a wholly-owned subsidiary of MPC (see "Stockholders Approve Merger" page 3 for additional details). The merger is currently before the ICC for approval.

The provisions of the mortgages and indenture relative to priority of call in each year upon "Available Net Income" (as defined therein) have been satisfied and no restriction under the mortgages and indenture exists on the Company's retained income at December 31, 1977.

Note 4 — Merger:

The merger of The Texas and Pacific Railway Company (T&P) and the Chicago & Eastern Illinois Railroad Company (C&EI) into the Missouri Pacific Railroad Company was consummated as a statutory merger as of October 15, 1976. The shares of the T&P and C&EI not owned by the Company were exchanged for 972,772 new shares of the Company's Common Stock. The T&P and C&EI were 96.7% and 78.3% owned, respectively, by the Company at the date of the merger. Assuming that the merger had occurred and the shares had been issued as of January 1, 1976, net income would have been increased by the income applicable to minority interest of $2,967,000 and earnings per common and common equivalent share would have been decreased $.08 for the year ended December 31, 1976.

The merger was accounted for under the "purchase" method of accounting. Under this method, $65,371,000 of excess of net assets (at acquisition) of consolidated subsidiaries over carrying value of investments (including $11,552,000 of "excess" generated at the date of exchange) was allocated to the railroad properties acquired based upon their relative fair values.

As a result of this allocation, net road and equipment properties presented in the accompanying consolidated balance sheet have been reduced $59,426,000 and $5,945,000, respectively.

Note 5 — Leased Assets and Lease Commitments:

The Company and its railroad subsidiaries lease a general office building, computer equipment and transportation equipment under long term and contingent lease agreements. Substantially all of the Company's long term transportation equipment leases meet the criteria of a capital lease as defined by Statement of Financial Accounting Standards No. 13 (SFAS 13) "Accounting for Leases", which was issued in November, 1976 by the Financial Accounting Standards Board. SFAS 13 defines a capital lease generally as one which transfers benefits and risks of ownership to the lessee, and requires that, for such leases entered into on or after January 1, 1977, the present value of minimum lease payments be recorded as an asset and an obligation. However, no such leases were entered into by the Company in 1977. Capitalization of long term capital leases existing at December 31, 1976 is required by the Securities and Exchange Commission no later than December 31, 1978.

A summary of rental expense charged to operations is as follows (in thousands):

	Year Ended December 31,	
	1977	1976
Minimum rentals under long term capital leases	**$ 9,025**	$ 8,465
Minimum rentals under long term operating leases	**2,425**	2,421
Contingent rentals and operating leases (net) —		
Hire of transportation equipment	**50,951**	46,208
Joint facility	**4,754**	6,253
Computer equipment	**1,809**	2,200
	59,939	57,082
	$ 68,964	$ 65,547

As of December 31, 1977, minimum rental commitments under long term leases were as follows (in thousands):

Year or Period	Capital leases	Operating leases
1978	$ 9,545	$ 2,480
1979	10,024	2,477
1980	9,923	2,270
1981	9,821	1,679
1982	9,821	810
1983 through 1994	53,221	5,873
Total	$102,355	$ 15,589

At December 31, 1977, the total of minimum rental commitments pertaining to capital leases was comprised of the present value of such commitments ($64,269,000) and of interest calculated at the Company's "incremental borrowing rate" at the inception of the leases ($38,086,000). On the assumption that SFAS 13 had been applied retroactively to January 1, 1976, leased assets and obligations at December 31, 1977 and 1976 would have been recorded as follows (in thousands):

	1977	1976
Leased equipment under capital leases, net of accumulated amortization of $24,418,000 and $18,830,000, respectively	**$55,658**	$61,280
Obligations under capital leases —		
Current	**$ 4,212**	$ 3,779
Long term	**60,057**	64,279
	$64,269	$68,058

On the assumption that the leases had been capitalized as shown above, and the assets amortized on a straight-line basis over the life of the leases and interest expense computed on the basis of the present value of the declining outstanding balance of the lease commitments, the impact on net income for the years ended December 31, 1977 and 1976 would not have been material.

The Company's leases on transportation equipment provide options to purchase the equipment at fair market value at the expiration of the leases. The lease on the general office building provides an option to renew the lease for four terms of five years each beginning in 1991 and an option to purchase the building for $6,000,000 at any time during the remaining life of the lease.

Note 6 — Contingent Liabilities:

The Company is contingently liable as guarantor, together with other owner railroads, for principal and interest of certain obligations of various affiliated companies aggregating approximately $118,323,000 at December 31, 1977. Under terms of a service interruption policy, the Company and its railroad subsidiaries are contingently liable for additional premiums up to a maximum of $24,729,000 in the event of work stoppages on other participating roads.

The companies have an insurance deductible of $5,000,000 per occurrence with respect to casualty losses resulting from destroyed equipment, freight loss and damage and fire and extended coverage risks and another $5,000,000 per occurrence with respect to personal injury and third party liability. At December 31, 1977, the Company has $5,900,000 set aside in capital, insurance and other funds to be used in the event of major uninsured losses.

Note 7 — Quarterly Financial Data (Unaudited):

Selected quarterly financial data for 1977 and 1976 appears on page 8.

Note 8 — Replacement Cost Data (Unaudited):

The impact of inflation on the Company's operating costs and its investment in property, plant and equipment has been significant. In recent years the Company has been able to compensate for higher operating costs through approved rate increases. However, replacing items of property, plant and equipment with assets having equivalent productive capacity has usually required substantially greater capital investment than was required to acquire such assets originally. Data showing the estimated replacement cost of the Company's properties and the related effect on depreciation expense is contained in the Company's 1977 Form 10-K filed with the Securities and Exchange Commission.

Condensed Consolidated Statement of Income For The Five Years Ended December 31, 1977

(In Thousands Except Per Share Data)

	1977	1976	1975	1974	1973
Operating Revenues	**$1,127,155**	$1,013,668	$888,546	$889,857	$753,582
Operating Expenses	**824,326**	747,242	667,694	673,315	584,296
Net Revenue from Operations	**302,829**	266,426	220,852	216,542	169,286
Other Operating Charges	**151,964**	141,161	117,238	118,573	97,439
Other Income (Net)	**20,412**	22,217	9,649	16,373	16,070
Interest Expense	**50,563**	45,773	44,101	41,648	38,600
Income Before Federal Income Taxes and Minority Interests	**120,714**	101,709	69,162	72,694	49,317
Provision for Federal Income Taxes:					
Current and Deferred	**57,372**	47,839	33,183	33,750	21,961
Investment Tax Credits Utilized	**45,540**	17,793	13,351	13,083	5,485
Less — Income Applicable to Minority Interests		2,967	2,615	2,305	1,946
Net Income	**$ 108,882**	$ 68,696	$ 46,715	$ 49,722	$ 30,895
Per Share Data:					
Earnings Per Common and Common Equivalent Share	**$ 8.08**	$ 5.40	$ 3.74	$ 3.98	
Cash Dividends Paid:					
Preferred		1.00	1.00	1.00	
Common	**1.59**	1.25	1.20	1.10	
Class A					$ 5.00
Class B					20.00
Weighted Average Number of Common Shares and Common Share Equivalents Outstanding	**13,467**	12,731	12,507	12,507	

Because of the characteristics of Missouri Pacific's Class A and Class B stock outstanding prior to the January, 1974 recapitalization, earnings per share data based thereon and weighted average shares outstanding have been omitted for 1973. Earnings and dividends per share and weighted average shares outstanding for 1974 reflect the five-for-one stock split of July 5, 1974.

Net income in 1977 includes $21,756,000 of non-recurring investment tax credits which were generated in previous years.

Management Discussion and Analysis of Statement of Income

Year 1977 vs 1976

1977 proved to be another record year for operating revenues. Freight revenue topped $1 billion for the first time in the System's history and was up 11.3% over the previous year. Revenue ton miles, considered an accurate barometer for measuring business growth, increased 6.3% during 1977. Freight rate increases granted during 1977 and the latter part of 1976 yielded approximately 5.4% over last year.

Operating expenses, up 10.3% in 1977, also reached an all-time high. Labor costs, spurred by two cost-of-living adjustments and a 4% general wage increase on July 1, rose 8.6% over 1976. Prices for material and supplies continued to rise during 1977 at a 7.3% rate while fuel prices per gallon increased almost 14%. Chiefly as a result of the labor and price increases, maintenance expense and transportation expense rose 13.4% and 8.2%, respectively.

Other operating charges reflected a $10.8 million increase over the previous year. Railway taxes were up $2.8 million, primarily from rises in property and state income taxes while payroll taxes increased $4.2 million due principally to an increase in unemployment tax rates as well as an addition to the railroad retirement maximum taxable base. Also, net charges paid to railroad and other companies for use of their equipment was $3.8 million higher than 1976, largely due to expenses resulting from significant rate increases in mileage related to certain types of private line cars.

Other income (net) showed a $1.8 million decrease as compared to the prior year. Profit on Company bonds reacquired dropped $2.2 million and profit on property sales was down $0.9 million but these decreases were partially offset by a rise in interest income from temporary and other investments of $1.7 million.

Interest expense rose $4.8 million in 1977. Record capital expenditures for new rolling stock caused a substantial increase in related financing, which produced the sizable increase in interest expense.

Federal income taxes dropped significantly from the previous year. Mainly responsible for the decrease was the ability to use the entire amount of over $21 million of investment tax credit carryover from prior years to offset the current year's taxes. A more detailed explanation of the fluctuation between 1977 and 1976 is included in Note 2 of Notes to Consolidated Financial Statements.

Year 1976 vs 1975

With an overall improvement in business conditions in 1976 as compared to 1975, operating revenues reflected a 14.1% increase. A combination of three factors contributed to this increase. First, revenue ton miles increased 6.8%; second, freight rate increases granted during the year yielded more than 7% over the previous year and third, there was a favorable change in the traffic mix.

Operating expenses also increased significantly in 1976, rising 11.9%. The trend of rising prices for material and supplies continued during 1976, up more than 6%. Labor costs also rose during the year due mainly to a 3% general wage increase effective April 1, and cost-of-living adjustments granted in January and July.

Other operating charges were up substantially in 1976, increasing $23.9 million over 1975. Railroad retirement taxes climbed more than $10.2 million, mainly as a result of an increase in the maximum taxable base while unemployment taxes rose $1.5 million, or 35%, due to an increase in the tax rate from 4.0% to 5.5%. In addition, net amounts paid to other railroads and private car lines for use of their equipment rose $8.7 million in 1976.

Other income (net) in 1976 increased $12.6 million, more than doubling 1975. The substantial rise was primarily attributable to increases of $6.2 million from profit on Company bonds reacquired, $2.4 million in income from less than majority-owned subsidiaries and $1.5 million in interest income.

Interest expense was up almost $1.7 million due to equipment obligations issued during 1976 to finance the large amount of new rolling stock purchased during the year.

Federal income taxes showed a significant increase in 1976 over the prior year principally due to the increase in pre-tax income but partially offset by a greater amount of investment tax credit. The effective tax rate rose slightly to 29.5% from 28.7% in 1975. The basis for computing the tax and the reasons for any fluctuations are not significantly different from other years.

Computation and Application of Available Net Income

Income of Missouri Pacific Railroad Company and its Wholly-Owned Railway Companies (as required by the Company's Mortgages and Indenture)
(In Thousands of Dollars)

	Year Ended December 31, 1977	1976
Income Before Fixed Charges and After Federal Income Taxes	**$158,690**	$ 91,716
Income of Wholly-Owned Railway Companies Before Fixed Charges	**4,209**	30,957
Road Property Retired and Charged (Credited) to Operating Expenses	**1,887**	(29)
	164,786	122,644
Less — Dividends of 100% Railway Companies Included in Missouri Pacific Income	**4,800**	5,558
Total Income Available for Fixed Charges	**159,986**	117,086
Fixed Charges	**40,186**	35,303
Available Net Income	**119,800**	81,783
Capital Expenditures Fund	**18,008**	15,737
Remaining Income	**101,792**	66,046
Sinking Fund on First Mortgage Bonds	**771**	771
Remaining Income	**101,021**	65,275
Interest on General Mortgage Bonds, Series A	**2,468**	2,451
Remaining Income	**98,553**	62,824
Sinking Fund on General Mortgage Bonds, Series A	**350**	350
Remaining Income	**98,203**	62,474
Interest on General Mortgage Bonds, Series B	**2,344**	2,330
Remaining Income	**95,859**	60,144
Sinking Fund on General Mortgage Bonds, Series B	**338**	338
Remaining Income	**95,521**	59,806
Interest on Income Debentures	**5,001**	5,001
Remaining Income	**90,520**	54,805
Sinking Fund on General and Refunding Mortgage Bonds, (T&P)	**1,527**	1,456
Remaining Income	**88,993**	53,349
Sinking Fund on First Mortgage Bonds (KO&G)	**66**	66
Remaining Income	**88,927**	53,283
Sinking Fund on Income Debentures (C&EI)	**123**	123
Available Net Income	**$ 88,804**	$ 53,160

Office of the Secretary

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